City and County of San Francisco

Office of the Controller - City Services Auditor

BOARD OF SUPERVISORS:

A Review of Comcast Corporation's Franchise Fee Payments July 1, 2000, Through December 31, 2002

FINANCIAL AUDITS DIVISION

October 21, 2004
02059

CITY AND COUNTY OF SAN FRANCISCO
OFFICE OF THE CONTROLLER

Ed Harrington
Controller

Monique Zmuda
Deputy Controller

October 21, 2004

Audit Number 02059

Board of Supervisors
City Hall, Room 244
1 Dr. Carlton B. Goodlett Place
San Francisco, CA 94102

President and Members:

The Office of the Controller presents its report concerning the review of franchise fee payments Comcast Corporation made to the City and County of San Francisco (City) to operate the cable television system within the City. Comcast is required to report its gross revenues arising from the operation of the cable television system each quarter and to pay five percent of the gross revenues as a franchise fee to the City. In addition, Comcast is required to pay cash grants for facilities and the support of public, educational, and governmental channels.

Reporting Period: July 1, 2000, through December 31, 2002

Franchise Fees and Grants Paid:	Franchise Fees	$13,663,058
	Grants	1,072,500
	Total	$14,735,558

Comcast correctly paid, in all material respects, the franchise fees due to the City on a timely basis. The report, however, identifies some areas in which the City needs to clarify the definition of revenues that should be subject to the franchise fee, and the need for Comcast and the Department of Telecommunications and Information Services to implement prior audit recommendations.

The responses of the Department of Telecommunications and Information Services and Comcast are attached to this report. The Controller's Audits Division will be working with the department to follow up on the status of the recommendations made in the report.

Respectfully submitted,

Ed Harrington
Controller

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INTRODUCTION

BACKGROUND

For most of the period under review, AT&T Broadband (AT&T) operated a cable television system for the City and County of San Francisco (City). On November 18, 2002, AT&T merged with Comcast Corporation to form the new Comcast Corporation, which now operates the cable franchise.

The City's cable television franchise ordinance (franchise agreement) requires Comcast to report its gross revenues arising from the operation of the cable television system each quarter and to pay five percent of the gross revenues as a franchise fee to the City. The franchise agreement requires Comcast to make franchise fee payments to the City within 90 days after the end of each quarter. The franchise agreement defines gross revenues as payments or other consideration that Comcast received in connection with providing cable service in the City. Comcast's revenues include various subscriber fees, such as fees for basic cable services, expanded basic, premium services, and pay per view, as well as revenues from shopping channel commissions and advertising sales. The franchise agreement also requires Comcast to make specified grant payments to the City over the term of the agreement.

SCOPE AND METHODOLOGY

The purpose of this audit was to determine whether Comcast correctly reported its gross revenues and correctly paid the City the franchise fees and grants due from July 1, 2000, through December 31, 2002. To determine whether Comcast correctly reported gross revenues for the audit period, we tested on a sample basis Comcast's supporting records. We also assessed the timeliness of Comcast's franchise fee payments. As part of our review, we interviewed staff from Comcast, the Department of Telecommunications and Information Services, and the Office of the City Attorney.

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AUDIT RESULTS

COMCAST CORRECTLY PAID ITS FRANCHISE FEES AND GRANT PAYMENTS

From July 1, 2000, through December 31, 2002, Comcast reported $273,261,159 in cable service gross revenues and paid $13,663,058 in franchise fees on a timely basis. In our opinion, Comcast correctly paid, in all material respects, the franchise fees due to the City. The table below shows the cable service gross revenues and franchise fees paid to the City for the audit period. In addition, Comcast is required to pay cash grants for facilities and the support of public, educational, and governmental channels. For the audit period, Comcast correctly paid $1,072,500 in grant payments to the City. However, because Comcast made the grant payments late, it agreed to pay an additional $50,589 in interest to the City.

TABLE

Reported Gross Revenues and Franchise Fees Paid
July 1, 2000, Through December 31, 2002

	Reported Gross Revenues	Franchise Fees Paid
July 1, 2000, through June 30, 2001	$106,984,082	$5,349,204
July 1, 2001, through June 30, 2002	110,639,430	5,531,972
July 1, 2002, through December 31, 2002	55,637,647	2,781,882
Total	$273,261,159	$13,663,058

THE FRANCHISE AGREEMENT'S DEFINITION OF GROSS REVENUES CONFLICTS WITH STANDARD INDUSTRY ACCOUNTING PRACTICES

The franchise agreement, Section 32.12, defines gross revenues as all cash, payments, or other consideration of any kind that Comcast receives in connection with providing cable service in the City, and specifies a list of some revenue sources. However, while this broad definition covers a number of revenue sources for which Comcast paid franchise fees, it does not provide sufficient guidance to determine whether some other revenues for which Comcast did not

pay franchise fees should be subject to franchise fees. We identified two revenues sources that Comcast did not include in the gross revenues it reported to the City that may be subject to the franchise fee.

Comcast Excludes Launch Fees From Gross Revenues

Comcast does not include in gross revenues the launch fees it receives from programmers for starting new networks that are included in Comcast's cable line-up. According to Comcast, a limited number of new networks pay Comcast a lump-sum launch fee to offset the cost of including the network in the cable line-up. Comcast informed us that it incurs certain programming costs for carrying the network, such as the costs for technical equipment to carry the network and advertising costs to promote the network's programs. Comcast did not provide us information on the amount of launch fees it received during the audit period. However, based on limited information that Comcast provided to us, we estimate that if Comcast were to include launch fees in the gross revenues it reports to the City, Comcast would pay additional franchise fees of roughly $50,000 per year. Comcast states that it is required under generally accepted accounting principles to treat the launch fees not as a revenue but as a reduction in its programming costs.

Because the franchise agreement does not explicitly address the treatment of launch fees and since the franchise agreement definition of gross revenues is broad, it may be valid to conclude that launch fees are payments received by Comcast for the cable system and subject to the franchise fee. Comcast may therefore need to report gross revenues to the City on a basis different than it recognizes revenues for its financial reporting purposes. However, because it appears that Comcast's accounting for launch fees is consistent with industry practice, we presently are not contesting the treatment of these fees. Nonetheless, the City reserves the right to pursue this matter in the future.

Comcast Includes Only Net Advertising Revenue in Gross Revenues

Comcast excludes commissions it paid to advertising agencies from the advertising revenues it reports to the City as part of the gross revenues. Comcast has arrangements with advertising agencies under which the agencies receive commissions of

approximately 15 percent of the gross advertising revenue. Comcast also has an arrangement with its national representative firm under which the firm receives commissions of 20 percent of the gross advertising revenue. Comcast includes only net advertising revenues in the gross revenues it reports to the City. The franchise agreement, Section 32.12(c), specifically addresses advertising revenue and appears to allow Comcast to report net advertising revenue. However, the agreement refers to a relationship with a specific advertising agency, and that relationship no longer exists. Thus, the agreement is not clear as to whether Comcast may report only net advertising revenue. We estimate that if Comcast were to include gross advertising revenues in the gross revenues it reports to the City, Comcast would pay additional franchise fees of approximately $80,000 per year. While we are not presently contesting the treatment of these revenues, the City reserves the right to pursue these revenues in the future.

COMCAST DOES NOT REPORT THE REQUIRED FAIR MARKET VALUE ON CERTAIN FREE SERVICES

Comcast does not include the fair market value of promotional free services in the gross revenue it reports to the City. According to the franchise agreement, Section 32.12, gross revenue includes the fair market value of any free services, except for the fair market value of any free services provided to the grantee's employees, to public buildings, or to non-profit organizations.

Comcast provides free services to customers on a promotional basis. Examples of such promotional free services include one month of free basic cable services, free installation of cable services, or two months of a free premium channel. Comcast does not include the fair market value of promotional free services in its gross revenues, and did not give us information on the imputed value of these free services it provided during the audit period.

Comcast does not believe that promotional free services provided to customers fall within the definition of gross receipts subject to the franchise fee. Comcast further asserts that paying franchise fees on these services would cause it to pay more than the limit of five percent of gross revenues. While we are not presently contesting Comcast's treatment of these revenues, the City reserves the right to pursue this matter in the future.

PRIOR AUDIT RECOMMENDATION REGARDING ADVERTISING REVENUES NOT IMPLEMENTED

In our prior audit report of the cable franchise fees dated November 20, 2001, we found that AT&T did not obtain City approval for using a procedure different than stated in the franchise agreement to report advertising revenues. Although AT&T's procedures appeared to result in AT&T reporting to the City the amount of revenues intended by the agreement, AT&T should have obtained the City's approval for the reporting changes. AT&T had claimed that this provision was applicable to a prior franchisee and, because of changed operating arrangements, this provision did not apply to AT&T. We recommended that the Department of Telecommunications and Information Services (DTIS) take any measures it deemed appropriate in response to AT&T's noncompliance with its franchise obligations for reporting advertising revenues. In addition, we recommended that AT&T seek an amendment to the franchise agreement to modify these obligations if it wished to continue to report advertising revenues in a manner that did not comply with its franchise obligations. According to Comcast, it uses these same reporting procedures as AT&T did for reporting advertising revenues.

To date, neither Comcast nor DTIS has resolved this matter. In DTIS's response to our November 2002 follow up of prior audit recommendations, DTIS's deputy director of policy, planning and compliance division stated that DTIS has been in negotiations with Comcast for several months regarding numerous noncompliance issues, including the issue identified in our audit. The deputy director also stated that DTIS has initiated action against the franchisee to resolve all issues of noncompliance, and this action is still pending. DTIS did not respond to our most recent follow up of prior audit recommendations in December 2003.

RECOMMENDATIONS

To ensure that Comcast Corporation pays all of the franchise fees that are due, the Department of Telecommunications and Information Services should take the following actions:

- Include a more precise definition of gross revenues that specifies revenue sources to be included or excluded from gross revenues in the new franchise agreement currently under development. It is also important to have a practical method of

addressing unforeseen revenue sources and whether they are to be included in gross revenues reported to the City.

- Determine in the new franchise agreement whether it is appropriate to include the fair market value of promotional free services in the definition of gross revenues subject to the franchise fee.

- Continue to take appropriate steps to implement the prior audit recommendation regarding Comcast's unauthorized procedures for reporting advertising revenues.

We conducted this audit according to the standards established by the Institute of Internal Auditors. We limited our audit to those areas specified in the audit scope section of this report.

Staff: Ben Carlick, Audit Manager
Helen Vo

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DEPARTMENT OF TELECOMMUNICATIONS AND INFORMATION SERVICES RESPONSE TO THE AUDIT:

CITY AND COUNTY OF SAN FRANCISCO

DEPARTMENT OF TELECOMMUNICATIONS & INFORMATION SERVICES

LEWIS W. LOEVEN III
EXECUTIVE DIRECTOR
TELEPHONE: 415.554.0801

DENISE BRADY, DEPUTY DIRECTOR
TELEPHONE: 415-554-7011 FAX: 415-554-0854

BRIAN ROBERTS
TELEPHONE: 415.554-0861 FAX: 415.554-0854

July 30, 2004

Ed Harrington
Controller
City Hall
1 Dr. Carlton B. Goodlett Place
San Francisco, CA 94102

Dear Mr. Harrington:

Thank you for giving DTIS an opportunity to review draft Audit Number 02059 "A Review of Comcast Corporation's Franchise Fee Payments July 1, 2000 through December 31, 2002" (Audit). We applaud you for investigating two areas not addressed in previous audits: launch fees and whether gross advertising revenue. However, DTIS cannot concur with the report.

DTIS believes that revenues generated by launch fees and gross revenues are included in Comcast's franchise definition of gross revenues and should be subject to franchise fees. (Ordinance 105-64 As Amended Through Ordinance 226-99) The draft audit estimates that including these sources of revenue would produce additional franchise fee revenue of $50,000 per year and $80,000 per year respectively. The franchise's inclusive definition of gross revenues means that revenues from sources that are not excluded, such as launch fees, should be included. In the case of advertising revenues, there was an exemption under specific circumstances from the general rule that franchise fees should apply to gross revenues. Those circumstances no longer exist, so the exemption should not apply. ① * ②

DTIS has several general comments on the draft Audit and how it interprets the cable franchise. DTIS believes that (1) the franchise's inclusive definition of gross revenues is reasonable; (2) under this inclusive definition of gross revenues, sources of cable revenue not specifically identified, such as launch fees, should be included in gross revenues and franchise fees should be applied; (3) the treatment of revenues prescribed by the franchise should prevail even when it may conflict with industry accounting practice; (4) the inclusive definition of gross revenues should generally be construed to include revenues that are not specifically excluded and (5) the franchise definition of gross revenues may become problematic if it is too specific. DTIS agrees that the definition of gross revenue could be improved; however, the existing franchise provides guidance on how to treat disputed classes of revenue, such as launch fees and advertising revenue. ③

* The Controller's Audits Division's comments on the Department of Telecommunications and Information Services' response to the audit are on page 15.

Thank you for your consideration.

Sincerely,

Brian Roberts for

Lewis Loeven
Executive Director

COMCAST CORPORATION RESPONSE TO THE AUDIT:

comcast.

Comcast Cable
183 Inverness Drive West
Englewood, CO 80112

June 29, 2004

Edward Harrington, Controller
Controller's Office
City Hall, Room 316
1 Dr. Carlton B. Goodlett Place
San Francisco, CA 94102

Dear Mr. Harrington:

We have received your draft audit report for the franchise fees that Comcast of California III, Inc. paid to the City and County of San Francisco for July 1, 2000 through December 31, 2002. Comcast was pleased no significant issues were found during the audit and that all payments, in all material respects, were determined to be paid in an accurate and timely manner.

Following are Comcast responses to the recommendations proposed in the draft audit report:

Recommendation #1

In drafting the new franchise agreement currently under development, include a more precise definition of gross revenues that specifies revenue sources to be included or excluded from gross revenues. It is also important to have a practical method of addressing unforeseen revenue sources and whether they are to be included in gross revenues reported to the City.

Response

Comcast concurs that both parties would benefit by adopting an updated and more precise definition of gross revenues that would specify revenue sources that should be included or excluded from gross revenue. We also agree that as the industry continues to evolve, it would be valuable to consider whether a practical approach could be developed to address unforeseen revenue sources that become available over the course of a franchise.

Recommendation #2

The new agreement should reconsider whether it is appropriate to include the fair market value of promotional free services in the definition of gross revenues.

Response

Comcast concurs any new agreement needs to address this issue. As stated in prior communication, Comcast does not believe it is appropriate to include the fair market value of promotional free services in the definition of gross revenues.

Recommendation #3

Continue to take appropriate steps to implement the prior audit recommendation regarding Comcast's unauthorized procedures for reporting advertising revenues.

Response

In regards to the prior audit recommendation concerning the use of unauthorized procedures for reporting advertising revenues, Comcast would like to assure the city that we are committed to reporting advertising revenues in compliance with the franchise agreement. The procedures stated in the agreement became obsolete requiring Comcast to develop a new method for calculating and reporting franchise fees. Prior to July 1996, BCA was a partnership with a number of cable operators in the Bay Area as partners. We recorded and paid franchise fees on TCI's percentage of revenue earned by the partnership. Revenue was allocated from BCA to the partners based on subscriber counts. In July 1996, TCI purchased the remaining portion of the partnership and recorded and paid franchise fees on 100% of the revenue placed on a particular system.

Finally, we appreciate the good working relationship experienced throughout the audit with Ben Carlick and Helen Vo. They demonstrated professionalism and objectivity throughout the engagement.

Sincerely,

Timothy T. Nester
Vice President /Controller
West Division
Comcast Cable Communications Inc.

CONTROLLER'S AUDITS DIVISION COMMENTS ON THE RESPONSE FROM THE DEPARTMENT OF TELECOMMUNICATIONS AND INFORMATION SERVICES:

To provide clarity and perspective, we are commenting on the response to our audit report from the Department of Telecommuncations and Information Services (DTIS). The following numbered responses correspond to the numbers we have placed in DTIS's response.

① While the franchise agreement specifically identifies the advertising agency affiliated with the prior franchise holder, we concluded that the exemption of paid commissions also applies to Comcast. Nonetheless, DTIS needs to clarify this provision of the franchise agreement and can include an alternate provision regarding advertising revenue that reflects current business operations.

② While DTIS believes the franchise agreement's definition of gross revenues is appropriate, from an audit perspective, the definition is lacking in precision. With the current broad definition, which is all cash received by the franchisee in providing cable service, there are a number of cash receipts types that we believe are not reasonably included in gross revenues. For example, the franchisee may have received deposits from customers, and these would be cash receipts of the franchisee, but we do not believe they are properly considered as gross revenues subject to the franchise fee. Because judgment is necessary to determine the gross revenues subject to the franchise fees, we have relied on industry financial accounting practices. While this factor is not controlling, in absence of a precise definition, we have looked to this factor to make a determination at to what should reasonably be included in gross revenues. It is important to understand that the role of audit is to render an objective opinion about the reported gross revenues. It remains for DTIS to negotiate with Comcast those revenues that DTIS believes should be included in gross revenues.

③ We concur that the franchise agreement can become too precise in defining gross revenues, such as was the case for advertising revenues. However, we are recommending that DTIS include a more precise definition of gross revenues that is not overly broad and specifies the types of revenues to be included or excluded from gross revenues, as well as having a practical method of addressing unforeseen revenue sources.

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cc: Mayor
Board of Supervisors
Civil Grand Jury
Budget Analyst
Public Library